

STATE OF CALIFORNIA
ELECTRICITY OVERSIGHT BOARD



Gray Davis, Governor

January 17, 2001

VIA E-MAIL FOR ELECTRONIC FILING

Hon. Linwood A. Watson, Jr., Acting Secretary
Federal Energy Regulatory Commission
888 First Street, NE
Washington, D.C. 20426

**Re: Investigation of Wholesale Rates of Public Utility Sellers of Energy and
Ancillary Services in the Western Systems Coordinating Council
Docket No. EL01-68-000**

Dear Mr. Watson:

Pursuant to Order No. 619, the Electricity Oversight Board hereby submits an electronic filing of its Request for Rehearing of the Commission's *Order Temporarily Modifying the West-Wide Price Mitigation Methodology* issued on December 19, 2001, in the above-referenced docket.

Thank you for your assistance.

Sincerely,

/s/

Grant A. Rosenblum
Staff Counsel
Electricity Oversight Board

cc: Official Service List of EL01-68-000

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Investigation of Wholesale Rates of Public Utility) Docket No. EL01-68-00
Sellers of Energy and Ancillary Services in the)
Western Systems Coordinating Council)

**REQUEST FOR REHEARING OF THE
CALIFORNIA ELECTRICITY OVERSIGHT BOARD**

Pursuant to the Commission’s Rules of Practice and Procedure, 18 C.F.R. § 385.713, and Section 313 of the Federal Power Act (“FPA”), 16 U.S.C. § 8251, the California Electricity Oversight Board (“Board”) hereby seeks rehearing in the above-referenced docket of the Commission’s December 19, 2001, “Order Temporarily Modifying the West-Wide Price Mitigation Methodology,” 97 FERC ¶ 61,294 (2001) (“Winter Order”).

I.

INTRODUCTION AND SPECIFICATION OF ERROR

The Commission issued the Winter Order to address the seasonal divergence between the Northwest - a winter peaking region - and California - a summer peaking region, even though, as the Winter Order acknowledges, the Western energy markets are currently stable and are anticipated to remain so. Indeed, current natural gas prices are less than half the price used to calculate the West-wide mitigated market clearing price (“MMCP”). Nor are natural gas prices during this winter season anticipated to rise, let alone rise sharply. Thus, the record refutes the Commission’s conclusion that changes in the West-wide pricing methodology are needed to accommodate the seasonal diversity.

More troubling, the Winter Order actually encourages anti-competitive market behavior. Specifically, the Winter Order discontinues reliance on a reserve deficiency in California to recalculate the MMCP. Instead, the MMCP is now reset at \$108, with the possibility of only upward adjustment to reflect rising natural gas prices. The MMCP cannot be recalculated downward. No longer will certain suppliers be exposed to the risk of triggering a reserve deficiency and the consequent downward recalculation of the MMCP under current market conditions. The Winter Order, therefore, has created an incentive for Northwest suppliers to undermine the “must-offer” requirement by withholding generation or to otherwise exploit a supply shortage in California in order to inflate market prices.

Thus, the Board respectfully seeks rehearing of the following specified errors contained in the Winter Order:

1. The Winter Order is not supported by the evidence on record in this proceeding; and
2. The Winter Order conflicts with the Commission’s prior orders mitigating the dysfunctions in the electricity markets in California and the West and violates the Commission’s mandate under the Federal Power Act to ensure just and reasonable rates.

II.

BACKGROUND

On June 19, 2001, the Commission adopted a mitigation strategy for sales into the markets operated by the California Independent System Operator (“CAISO”) as well as for bilateral spot market sales throughout the Western Systems Coordinating Council

(“WSCC”).¹ Under this mitigation plan, during periods of reserve deficiencies in California, the CAISO market clearing price is calculated based on a formula that seeks to reflect the marginal cost of the last unit dispatched.² This CAISO mitigated market clearing price (“MMCP”) also serves as a limit on the price of all other spot market sales throughout the WSCC during reserve deficiencies in California. Sellers, other than marketers, possess the right to attempt to cost justify transactions above the MMCP. Prices during non-reserve deficiency hours cannot, absent justification, exceed 85 percent of the highest hourly MMCP that was in effect during the previous Stage 1 reserve deficiency period called by the CAISO. Under the June 19 Order, the mitigation plan was to remain in effect until September 30, 2002.³

The Winter Order suspends the West-wide methodology adopted in the June 19 Order through April 30, 2002. The Commission reset the MMCP for all hours equal to the current MMCP under the June 19 Order methodology of \$108/MWh. The Winter Order, therefore, eliminates the differential between reserve and non-reserve hours, i.e., 85 percent of the MMCP. Nor will the MMCP for transactions outside the organized CAISO markets be recalculated when a reserve deficiency occurs in California. Instead, the Winter Order requires the CAISO to recalculate the MMCP when the average of the

¹ *San Diego Gas & Electric Company et al.*, 95 FERC ¶ 61,418 (2001) (“June 19 Order”).

² Using the June 19 Order methodology, the MMCP was set at \$108/MWh for the last applicable reserve deficiency period on May 31, 2001. The MMCP is based on a gas index of \$6.641/MMBtu, a generating unit with a heat rate of approximately 15,360 Btu/MWh and \$6.00 O&M adder. (Winter Order, slip. op. at p. 8.)

³ June 19 Order at 62,548 – 62,549.

three natural gas indices referenced in the June 19 Order increases at least 10 percent above the level last used for calculating the mitigated price.⁴

III.

ARGUMENT ON REHEARING

A. The Record Fails To Support The Need for Changes to the West-Wide Pricing Methodology

The Commission admits the WSCC is experiencing record high working natural gas storage volumes and favorable weather conditions that have increased the region's hydroelectric reserves.⁵ Spot prices for natural gas in the West have ranged from \$2.43 MMBtu to \$2.93 MMBtu, or 63% to 56% less than the \$6.60 MMBtu price utilized in setting the MMCP.⁶ The projection is for natural gas prices to continue falling.⁷ As a result of these market conditions, spot prices for electricity at the major trading hubs have been consistently below \$40/MWh.⁸ The superseded MMCP was \$92/MWh. Thus, the prior West-wide methodology would have accommodated a greater than 100 percent increase from current prices of natural gas and electricity and nothing in the current record supports that fossil generators cannot, or will not, be able to recover costs under the prior mitigation scheme given present market conditions.⁹

⁴ Winter Order, slip. op. at p. 8.

⁵ *Id.*, slip. op. at p. 6.

⁶ *Id.*, Massey Dissent, at p. 1.

⁷ *Id.*, citing Energy Information Administration.

⁸ *Id.*, slip. op. at p. 6.

⁹ Richard Tabors, witness for the Transaction Finality Group, stated “[l]oad serving entities in the Northwest have (as they traditionally had in the past) the majority of the winter peak load covered by long term contracts.” (Statement of Richard Tabors for Technical Conference Considering West-Wide Price Mitigation on Behalf of Certain Members of the Transaction Finality Group, Docket No. EL01-68-000

The Commission abandoned the use of the reserve deficiency model as a trigger for recalculating a new mitigated price for winter purportedly because the WSCC, outside of California, is composed of numerous control areas with no centralized market.¹⁰ Two uncontroverted facts render this justification irrational and wholly unsupported by the record.

First, the Commission has recognized that the Northwest electricity market is not independent of California. In the Commission's June 19, 2001 Order, the Commission noted that the "West is a single market which is at once inextricably interrelated . . ."¹¹ Indeed, a major consideration of the Commission in electing to extend price mitigation to the entire WSCC area was its conclusion that "[t]here is a critical interdependence among the prices in the ISO's organized spot markets, the prices in the bilateral spot market in California and the rest of the West, and the prices in forward markets."¹² Stated simply, prices in California and the rest of the West generally fluctuate together.

Second, the Commission confirmed in the Winter Order that the record supports reliance on a gas fired unit as the marginal unit for calculating the MMCP during the winter season.¹³ In so doing, the Commission recognized that hydroelectric units in the Northwest are infra-marginal. Thus, the record rebuts the Commission's concerns that a

(Oct. 26, 2001).) Suppliers subject to such long-term contracts typically secure a corresponding long-term supply of gas, which under recent market conditions would be at low prices. Moreover, to the extent suppliers entered into long-term contracts while prices were inflated, the Winter Order does nothing to ensure recovery of costs because the MMCP is calculated based on future changes in natural gas prices.

¹⁰ Winter Order, slip. op. at pp. 7-8.

¹¹ June 19 Order at 62,545.

¹² *Id.* at 62,547.

¹³ Winter Order, slip. op. at p. 8.

lowering of the MMCP due to a California reserve deficiency will prevent suppliers from recovering costs and hydroelectric units from participating in the market.

B. Disconnecting Recalculation Of The MMCP From A Reserve Deficiency In California Encourages Market Manipulation

The Commission has repeatedly found that the market structures and rules for wholesale sales of electric energy in California are seriously flawed and that these conditions have caused, and continue to have the potential to cause, unjust and unreasonable rates for short-term energy.¹⁴ The Commission responded to the California crisis by issuing a series of directives, including the West-Wide mitigation strategy, to correct the dysfunctions in wholesale power markets in California and the West.¹⁵ The Winter Order, however, conflicts with this objective and the Commission's mandate to ensure just and reasonable rates.

The Winter Order resets the MMCP at \$108 (eliminating the 85% limitation for non-reserve deficiency hours). It further allows for adjustments upward only. At least during the winter season, the MMCP will not be recalculated at the time of a reserve deficiency in California. Accordingly, the Winter Order has eliminated any negative consequence to suppliers withholding generation. No longer will suppliers have to worry about triggering a reserve deficiency and the consequent downward recalculation of the MMCP under current market conditions. If shortages occur in California because of withholding or other reasons, sellers will be able to push prices up to the MMCP, which will not bear reasonable relationship to sellers' marginal costs. Thus, by removing the

¹⁴ *San Diego Gas & Electric Company, et al.*, 93 FERC ¶ 61,121 (2000) at 61,349; *San Diego Gas & Electric Company, et al.*, 93 FERC ¶ 61, 294 (2000) at 61,984.

¹⁵ Winter Order, slip. op. at p. 2.

possibility of resetting the MMCP based on a shortage of supply in California, the Winter Order invites anti-competitive behavior.

No other aspect of the Commission's mitigation plan offsets the elimination of the positive incentive under the old methodology to offer power. The must-offer requirement is manifestly inadequate. The must-offer requirement applies only to those units that are available, i.e., not on a planned or forced outage (assuming the supplier has given the CAISO proper notification). The post-hoc detection of illegitimate generation outages simply cannot substitute for a rule embedded into the market structure. Moreover, the must-offer requirement does not obligate generators outside California to offer supply to the CAISO.

IV. CONCLUSION

For the reasons set forth above, the Board respectfully requests that the Commission grant rehearing of the Winter Order and rescind the changes to the West-wide mitigation methodology articulated in that order.

Dated: January 17, 2002

Respectfully submitted,

Grant A. Rosenblum

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CERTIFICATE OF SERVICE

I hereby certify that I have caused the foregoing document to be served upon each person designated on the official service list compiled by the Secretary for this proceeding on or before January 17, 2001, pursuant to Rule 2010(a) of the Commission's Rules of Practice and Procedure.

Dated at Sacramento, California, this 17th day of January, 2001.

/s/

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